2003

Not-for-profit organizations industry developments - 2003; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Not-for-Profit Organizations Industry Developments—2003

Complement to AICPA Audit and Accounting Guide *Not-for-Profit Organizations*

American Institute of Certified Public Accountants

AICPA

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150, "Generally Accepted Auditing Standards"). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

This Audit Risk Alert helps you plan and perform your not-for-profit organization (NPO) audits. The information delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the not-for-profit industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry information and understanding it.

Economic and Industry Developments

The State of the Economy

The slow economy that has affected the nation since 2001 continues. Uncertainty permeates the financial markets and the labor market continues to worsen. The slow economy causes many consumers to agonize about their personal prospects and causes businesses to be more averse to locking into major financial commitments, investments, and significant job creation. However, the economy is well positioned for improved expansion.

Fundraising has suffered under the current economic conditions. According to the GuideStar survey, nearly half of not-for-profit organizations surveyed reported a drop in donations for the first 10 months of the year, while 22 percent said contributions remained the same. Donors are concerned about the future of the economy and more skeptical about how charities operate. As the net worth of major contributors declines, so do their gifts to charities. A wide variety of charity recipients are being affected as major donors cut their donations in response to losses brought on by the most significant market downturn in 30 years. In addition, some large employers have stopped matching their employees' charitable donations.

In the face of these uncertain economic times, NPOs may consider using "creative" budgeting, financing, and financial reporting techniques to avoid the appearance of deficit financial positions. They may attempt to find innovative ways to minimize the reporting of costs, maximize the reporting of contribution revenues and unrestricted net assets, and use restricted resources for unrestricted purposes. Some of these methods may be inappropriate and even fraudulent.

To help you consider and address these pressures being placed on management and the audit risks that may arise, the recently issued Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316), and its associated Implementation Guide provide extensive audit requirements and how-to guidance. Among its provisions, SAS No. 99 expands the procedures you should take to consider the potential for misstatements from fraud, including those arising from fraudulent financial reporting. In addition, see the new appendix to Chapter 2, "General Auditing Considerations," of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* for further guidance on SAS No. 99.

Continuing Weak Economy and Fund-Raising Challenges

As endowments decline, competition for donor dollars rises, and cuts in government, corporate, and foundation funding continue, not-for-profit organizations are forced to cut back spending to preserve assets. Meanwhile the need for programs and services continues to increase, creating pressure for not-for-profits to do more with less. With fewer resources something has to give.

Some NPOs may ultimately do without the resources necessary to maintain effective internal control.

Proper accounting related to an organization's endowments may become a concern as negative returns and stock market declines take their toll. See the "Accounting Issues and Developments" section of this Alert for how to account for endowment losses.

The Advantages of Audit Committees

Unfortunately, many NPOs operate without an audit committee. Following Enron, WorldCom, and other similar financial scandals, some occurring within the NPO arena, the audit committee has resurfaced as a vital instrument for strengthening sound financial management and fraud prevention.

Audit committees can help the board of directors become aware of and put a stop to financial mismanagement within an organization. Audit committees can help the board of directors oversee the NPO's internal control and the financial reporting process. In addition, audit committees can act as a buffer between management and the auditor, as well as improving the communication between the outside auditor and the board of directors.

NPOs can be particularly susceptible to fraudulent activities. NPOs operate in an atmosphere of trust with reliance on volunteers to execute crucial tasks with continual influxes of cash donations. Supervision and resources are limited, and a voluntary board of directors may lack financial expertise. NPOs may want to consider maintaining an audit committee and educating their directors and audit committee members about their roles and responsibilities.

Taxation of Internet Sales

The taxation of Internet sales remains an ongoing issue. State and local governments are concerned about losing billions of revenue dollars annually because of untaxed Internet sales. Internet businesses claim that disparities in sales tax systems among the various jurisdictions make it too burdensome to administer sales tax collections.

Late in 2002, a majority of states approved an interstate agreement to simplify their sales tax laws. The agreement will become effective once a certain number of states have enacted conforming legislation. In response, some of the nation's largest retailers have started voluntarily to collect taxes on their Internet sales. However, before state and local governments can enforce the taxation of Internet sales, the federal government must pass legislation permitting it. The Internet Nondiscrimination Act (Public Law [P.L.] 107-075), which expires November 1, 2003, bans new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce. Legislators have introduced bills in the 108th Congress to make the ban permanent. Surely, the states will be adding their voices to that debate.

Regulatory and Legislative Developments

Auditors of NPOs may need to monitor changes in government regulations for various reasons. For example, they may be required to comply with Government Auditing Standards (GAS), also referred to as the Yellow Book.[1] In addition, auditors may be required to perform a single audit and comply with applicable rules. A *single audit* is an audit of an entity's federal financial assistance, as required by the Single Audit Act Amendments of 1996 (the Act), and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).[2] NPOs may also be affected by other federal, state, and local laws, such as laws regulating the registration of NPOs and tax laws.

In the past the NPO Audit Risk Alert has discussed developments related to the following regulatory matters:

- Circular A-133 Audit Guidance Update

1. Although *government auditing standards* primarily apply to federal assistance, some states have adopted government auditing standards.
2. Instead of a single audit, under certain circumstances program-specific audits may be conducted.

- Annual Compliance Supplement—Issued to help you understand the objectives, procedures, and compliance requirements of approximately 160 federal programs.
  - Data Collection Form Revision and Electronic Submissions
  - Federal Grant Streamlining Program
  - Orange Book
  - Circular A-133 Audit Reviews
- Government Auditing Standards

Discussions of those developments will now appear in the AICPA Audit Risk Alert *Single Audit—2003, Audits of Organizations Receiving Federal Awards: Single Audits Performed in Accordance with Office of Management Budget Circular A-133.*

Internal Revenue Service Activities

Revised Filing Requirements for 527 Political Organizations

The IRS has outlined new reporting requirements that exempt many state and local political organizations from filing certain forms.

The new law changes filing requirements for many political organizations that have tax-exempt status under section 527 of the Internal Revenue Code. The changes are retroactive to July 1, 2000, when the reporting requirements became mandatory.

The new law:

- Exempts state and local candidate and party committees from filing Form 8871 and Form 990 (or 990-EZ);
- Exempts qualified state and local political organizations (QSLPOs) from filing Form 8872;
- Exempts political committees filing with the Federal Election Campaign (FEC) Act of 1971 from filing Form 990 (or 990-EZ);

- Exempts political organizations that are a caucus or association of state or local officials from filing Form 990 (or 990-EZ);
- Requires additional information on Form 8871 and Form 8872;
- Requires the filing of an amended Form 8871 after material changes to maintain tax-exempt status;
- Increases reporting thresholds for certain Form 990 filers;
- Eliminates the requirement to file Form 1120-POL except when an organization has taxable income after taking the $100 specific deduction (returning to pre-July 2000 requirements);
- Reinstates the pre-July 2000 confidentiality requirement for any Form 1120-POL filed after November 2, 2002; and
- Changes the electronic filing requirements by:
  – Requiring that Form 8871 be filed electronically (as opposed to both in writing and electronically); and
  – Requiring that any Form 8872 due after June 30, 2003, be filed electronically if the filing organization has or expects to have contributions or expenditures of more than $50,000 during the calendar year.

A more complete description of filing requirements for political organizations can be found in Fact Sheet 02-13. For further information, visit the IRS Web site at www.irs.gov/polorgs or call the IRS Tax Exempt Customer Account Service toll-free number at (877) 829-5500.

IRS Quest to Improve Form 990

The IRS is attempting to alter federal Form 990 to improve its content and accountability. In the wake of numerous accounting scandals and demands for greater financial disclosure, the IRS is requesting greater financial disclosures by not-for-profits. The IRS is proposing changes to Form 990 in the following areas:

- Foreign grants
- Fundraising
- Whether an organization has an independent audit committee
- Conflict of interest policy
- Other disclosure issues, such as:
  - If the NPO should provide more information than currently required about financial relationships with "substantial" contributors, directors, officers, and other key employees.
  - Whether noncharitable exempt organizations should disclose transactions with "substantial" donors, officers, directors, trustees, and key employees, similar to the disclosures of schedule A, Part III, Question 2.

The IRS is also proposing other changes such as whether organizations should have to complete Part II of Form 990 in accordance with Statement of Position (SOP) 98-2, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Government Entities that Include Fund-Raising.* The IRS feels that it will simplify the comparisons performed regarding an organization's fund-raising costs and produce greater uniformity. In addition, the IRS is asking whether organizations should be required to file a separate schedule detailing grants to foreign organizations and whether domestic organizations involved in foreign activities should give more specific information about money flow in those activities or about recipients in response to potential terrorist activities.

Furthermore, IRS Announcement 2002-87 also brings not-for-profits up-to-date on recent changes to Form 990 including the requirement for organizations to report the gross amount raised by an outside fundraiser on Part I, line 1a since, according to the IRS, some organizations were reporting the net amount received, which allowed not-for-profits to evade reporting expenses such as fund-raising fees.

Comments were due back to the IRS by January 28, 2003. As of the writing of this Alert the IRS had not finalized the possible changes yet. Readers should keep an eye out for these proposed changes.

Proposed Changes to Form 1023

The IRS is proposing revisions to Form 1023, "Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code," and the instructions for Form 1023. The proposed revisions are quite extensive.

Listed below are some of the more significant changes the revisions call for:

- The revised Form 1023 would require information concerning foreign activities in response to political uneasiness that some U.S. charities may have assisted in financing international terrorist activities. For example, whether the applicant was formed or has operations in a foreign country or contributes to foreign organizations the applicant must explain how control and discretion is maintained when it comes to the use of money or material given to foreign organizations.
- The proposed revisions to Form 1023 would require the applicant to include details to determine if the compensation of the officers, directors, and trustees of the applicant is reasonable. The details include each person's qualifications, hours worked, and duties performed. A short resume for each compensated executive may be suitable according to the revised proposed instructions.
- The proposed revisions to Form 1023 would require an explanation of agreements and copies of pertinent documents to be submitted if there are any leases, contracts, or other agreements between the organization and those who control it, or with other entities, whether exempt or for-profit, over which they have "substantial influence." Substantial influence is defined as the ability to affect decisions either as an officer, shareholder, or owner. The details to be

included in the required explanation would take into account how the terms of the agreement were attained and how the conflict of interest was settled to attain an unbiased decision.

- The revised Form 1023 would include Part VIII, which is composed of 8 questions aimed at identifying potential unrelated business income. For instance, the IRS is requesting to be acquainted with the facts if the applicant performs any of the following:
  - Conducts activities over the Internet
  - Provides managerial or consulting services to other exempt organizations for a fee
  - Generates income from intellectual property (for example, patents and copyrights)
  - Operates bingo and other gaming activities
  - Conducts other activities that do not directly accomplish its charitable, educational, or religious purposes

As of the writing of this Alert the IRS had not finalized the proposed revisions. Readers should keep an eye out for these proposed changes.

IRS e-file: Exempt Organizations Tax Form Schemas

Preparers should be aware that the IRS now has available the proposed IRS e-file Exempt Organization Tax Schemas for the 2002 tax year. The IRS provides a zip file which consists of the schemas for Forms 990 and 990-EZ (which includes Schedules A and B), Form 1120-POL, and Form 8868. Comments were due back prior to March 24, 2003. The final release of the schemas was scheduled for March 31, 2003.

Employer Leave-Based Donation Programs

As discussed in last year's Alert some employers adopted a "leave based donation program" following the terrorist attacks of September 11, 2001. The program permitted employees to give up paid vacation, sick, or personal time off in return for the employer's contribution of specified dollar amounts to charitable organizations.

Usually, an employee who designates compensation to a charity is still considered to have received it for income tax purposes (Reg. 1.61-2 (c)). In spite of this, the IRS proclaimed that amounts donated to charity under leave-based programs before January 1, 2003, would not be included in participating employees' gross income for income tax and payroll tax purposes according to Notice 2001-69. Because no income is recognized, a participating employee would not be entitled to a contribution. Furthermore, employer payments under leave-based programs prior to January 1, 2003, were to be treated as ordinary business expenses to the employer instead of charitable contributions.

Notice 2001-69 has been revoked by the IRS. Practitioners should refer to Notice 2003-1 which states that such payments made on or after January 1, 2003, will be includible in an employee's gross income and deductible only as a charitable contribution.

Revenue Rulings on Electric Cooperatives' Exemption

IRC section 501(c)(12) provides for the exemption of cooperatives that receive at least 85 percent of their income from members for providing certain public utility services. Revenue Rulings 2002-54 and 2002-55 provide additional guidance on how to calculate this member income test.

Private Letter Ruling on Advertising Implications of Web Activities

The IRS has taken the position that the practice of exchanging links to other Web sites or banners with other online organizations may result in taxable advertising income. The IRS will determine this based on the facts and circumstances in each case. Practitioners may refer to Private Letter Ruling (PLR) 200303062 for additional guidance on the potential tax implications of Web site links.

The Better Business Bureau Wise Giving Alliance

The Better Business Bureau (BBB) Wise Giving Alliance is a charity watchdog whose objectives include assisting donors in making knowledgeable and informed giving decisions. In March 2003, it issued new charity accountability standards. These standards supersede the standards of the former National Charities Information Bureau (NCIB) and the Council of Better Business Bureaus Foundation and its Philanthropic Advisory Service (PAS) which were all merged in 2001 to create the BBB Wise Giving Alliance.

The BBB Wise Giving Alliance Standards for Charitable Accountability address the following accountability issues:

- The charity's use of funds and fund-raising practices.
- Donor privacy protection.
- Charity Web site disclosures.
- The importance of spending funds in accordance with donor intentions.
- Recommendation that the charity institute an effectiveness measure to assess its performance.

The BBB Wise Giving Alliance has developed the "Wise Giving Seal" which will guarantee donors that the charity operates in accordance with these thorough standards. Qualified charities will have authorization to display the seal in their solicitation material, advertisements, and other items signifying that they have met the Alliance standards. The seal is scheduled to be available this summer.

An Implementation Guide for the Standards for Charitable Accountability has been developed by the Alliance. It provides detailed guidance on how each standard should be applied and their effective dates.

The BBB Wise Giving Alliance Standards for Charitable Accountability and the Standards Implementation Guide can be found at www.give.org.

Sarbanes-Oxley Act and Not-for-Profits

Although the Sarbanes-Oxley Act (S-O) is only applicable to public companies and their auditors, it could have a ripple effect on not-for-profit organizations. For example, in late January 2003, the New York State Attorney General's Office announced proposed requirements for nonprofits, which mimic the requirements of S-O. S-O-like provisions that could pass through to not-for-profit organizations in the future may include the certification of financial statements, increased disclosures, improved role of the audit committee, and code of conduct rules for CFOs and other senior financial officers. Readers should monitor the AICPA Web site for news about S-O and related developments.

Audit and Attestation Issues and Developments

The Internet and Internal Control Issues

The Internet as a communications and direct response channel is on the rise in the not-for-profit arena. Large and small not-for-profits are using the Internet to develop strong constituent relationships to maximize fund-raising efforts. NPOs can use the Internet for marketing services, driving advocacy, recruiting volunteers, and acquiring and retaining both annual giving and major donors.

NPOs are using the Internet for theme-based appeals, which explain how one's donation will be used, and volunteer-based fundraising. With annual giving and membership programs yielding poor returns of 30-50 percent of supporters from year to year, and the cost of paper-based communications rising, the Internet appears to be a promising vehicle for helping NPOs raise significant dollars. As more and more not-for-profits welcome the Internet as a powerful tool, the auditor faces new challenges.

Audit Timing and Planning

NPOs with online donation transactions may automatically initiate, authorize, record, summarize, and settle transactions electronically without human intervention or physical documentation. As a result, key audit evidence in electronic form may exist only for a limited amount of time. Therefore, you will need to understand and be able to rely on information technology (IT) general controls. Computer programs may summarize transactions on a periodic basis and then purge, update, change, modify, or write over the original detail records of the transaction. Traditionally, audit procedures are performed after a client's fiscal year end. With Internet activities, however, traditional audit timing may be inadequate. One audit implication of sometimes short-term electronic evidence in audits of NPOs with online donations is that waiting until after the fiscal year end to begin auditing procedures may be too late to obtain competent sufficient evidence of controls or transactions.

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.09), indicates that "the extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures."

The NPOs conducting e-philanthropy may not have hard-copy or paper evidence of transactions. Contribution statements, delivery, settlement, and authorization may be prepared and performed electronically, leaving no paper trail behind. The failure of NPOs to retain the details of transactions can create troublesome issues for the auditor who is considering whether internal control is functioning as planned. According to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.18), as amended:

> Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls.

If the retention of evidential matter is questionable, the auditor may want to begin audit procedures before year end. This may also drive the need for continuous auditing.

Adequate Technical Training

The rapid evolution of technology has profound implications for all those affected by computer technology, including auditors. Existing NPO e-philanthropy hardware and software may need to be replaced every 18 months, or more frequently, to remain competitive. This rapid rate of technological change means that, to remain current, ongoing training in the underlying Internet technologies is requisite.

Auditing through the computer and the nature of electronic evidence require that the auditor gain a more detailed understanding of the controls over transactions and records than that traditionally obtained for paper-based manual audits. You can obtain more specific technology skills through technical training courses, seminars, IT reference materials, research, and other methods.

> **Help Desk—**The AICPA provides the following courses that are helpful to CPAs working in the environment of e-business activities: Auditing in a Paperless Society (Product No. 730121kk) and E-Commerce: Controls and Audit (Product No. 731550kk). How can you develop strategies for auditing around, through, and with a computer? Learn how a wide spectrum of technologies is redefining the role of auditor and auditee in these self-study courses. They are available from the AICPA Order Department at (888) 777-7077.

Using the Work of a Specialist

Due to the rapid advance of technology, you may not have all the skills necessary to audit online activities. Until you and your staff have the technical skills needed to audit NPO e-philanthropy of online donations, you may need to engage IT audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, you may have to go outside your own organization to obtain qualified specialists. Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to SAS No. 73, *Using the Work of a*

Specialist (AICPA, *Professional Standards*, vol. 1, AU sec. 336.06), specialized assistance is advisable for auditors who:

> …may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skills or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

The use of an outside specialist[3] in an Internet context does not absolve the auditor from a certain level of understanding about computers. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. According to SAS No. 22 (AU sec. 311.10):

> If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

Internal Control as It Affects Audit Evidential Matter

SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). For traditional businesses, the auditor's

3. Note that SAS No. 73 does not apply to specialists who are employed by the firm and are part of the engagement team. SAS No. 73 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

consideration of internal control typically involves updating prior-year checklists, questionnaires, and procedural narratives. Using a traditional audit approach for e-philanthropy NPO clients would be insufficient because, in the e-philanthropy environment, almost all of the evidence of transactions is electronic. Critical records may consist of e-mail, database records, electronic documents, spreadsheets, and server logs. In addition, e-philanthropy transactions are subject to intentional and unintentional alteration and manipulation at many points between transaction initiation and summarization in the financial statements. Because NPO e-philanthropy segments generally lack much of the paper evidence found in audits of traditional businesses, your approach to understanding internal controls when planning the e-philanthropy audit and determining the nature and extent of substantive tests should take this into account.

SAS No. 55, as amended, provides guidance to auditors about the effect of IT on internal control and on the auditor's understanding of internal control and assessment of control risk. In some circumstances, auditors may need to perform tests of controls to perform an effective audit.

The Importance of Software Controls

As noted earlier, technology continues to evolve rapidly. Most server software is constantly upgraded, modified, and configured with components from different vendors. Often, when software is upgraded, previous control settings are lost, with no warning to managers. If procedures are performed before year end, you have the additional responsibility to consider whether there are frequent and significant changes being made to the NPO systems that might affect the remainder of the period. According to SAS No. 55 (AU sec. 319.99):

> When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period…The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies,

procedures, and personnel, that occur subsequent to the interim period.

Access is another issue to consider when testing controls over online activities. To test controls, auditors need access to networks, servers, and databases on which entities store their accounting records. Information technology managers may be reluctant to grant auditors the level of access they need, preferring, instead, to provide lengthy printouts, files on diskettes, or files as e-mail attachments. Access to copies of records in these forms is insufficient. Auditors should have full read-access rights to all system and database security settings and tables as well as the underlying electronic accounting records to gain a sufficient understanding of controls and to perform substantive tests.

E-philanthropy software should include controls to prevent the repudiation or alteration of records that initiate transactions. Such controls might include digital signatures or server certificates that authenticate the parties to the transaction, as well as traditional edit and validation controls. Electronic (digital) signatures reduce the likelihood of the parties claiming that they never initiated the transaction or that the record of the terms of the transaction has been altered. Without server certificates, an initiator of a transaction has no assurance that it is dealing with the intended party's computer. Without digital signatures and server certificates, it may be difficult to determine that transactions are neither fictitious nor fraudulent.

The Importance of Monitoring

A key control in a system of internal control is monitoring. Routers, firewalls, Web servers, e-mail servers, databases, and operating systems all have the ability to log traffic and specific security events. Properly implemented and controlled logs can provide some evidence that a transaction occurred and that the transaction record has not been altered. Independent audits of the controls carried out at third parties, along with the use of digital certificates, encryption, access controls, and logging, help provide evidence for the auditor regarding the integrity of recorded transactions.

Key Controls in an Electronic Environment

To reduce the chance of an auditor relying on evidence that lacks credibility, he or she should understand the key controls over validity, completeness, and integrity. In the electronic environment, these typically include the following:

Segregation of Duties. Different employees should perform the duties of security administration, security monitoring, system administration, application maintenance, software development, and daily accounting operations.

Authorization. User access to networks, systems, servers, services, programs, data, and records should be authorized based on the organization's security policy and documented.

Authentication. The identity of authorized users should be established by the use of logon IDs, hard-to-guess and hard-to-crack passwords, and, where appropriate, smart cards.

Access Limitations. Authorized users should be granted access to networks and application systems only after they authenticate themselves, and their access rights should be commensurate with their job responsibilities.

Activity Logging. Logging should be enabled on all routers, firewalls, servers, databases, and operating systems. The logs should be protected from tampering and alteration and should be retained.

Independent Monitoring. Employees independent of the IT department should monitor the activity logs on a frequent enough basis to detect suspicious, unusual, and unauthorized activity. Due to integration of e-philanthropy as discussed above, it should be independent of operations including IT.

Methods of Error Correction. Software should have controlled rollback procedures so records are not purged or lost when servers crash and programs abort. Controls preventing changes to historical records should be in place so errors are corrected by entries made by the accounting department. Programmers and other IT personnel should not be able to make changes to actual accounting records.

Backup Procedures. Grandfather, father, and son daily backup procedures should be performed, as well as weekly, monthly, quarterly, and annual backups. All files that include the details of transactions should be included in the backup. With the advice of legal counsel, the key user or owner of the data should establish retention schedules to satisfy legal and regulatory requirements. The backup media should have clear exterior identification, and there should be an offline log and inventory of what was backed up, when, by whom, and where stored. Backups should be stored in a safe location off-site and tested periodically by the key user of the data.

Disaster Recovery. The nature of online services often requires that systems be capable of operating 24 hours a day, seven days a week. Even short periods of outage may mean significant financial loss to some NPOs. There should be a written plan on how systems will roll over to alternative systems should the data center be destroyed or rendered inoperable. The plan should periodically be tested.

The strength of controls in an electronic environment is like a chain, where strength is determined by the weakest link. You should consider whether any weak links are present and, if so, consider the need to adjust your risk assessment and substantive tests accordingly.

Reports From Service Organizations

Many clients use an Internet service provider (ISP) or application service provider (ASP) to host their Web site, including the databases used to initially record contributions and credit card receivables. In a number of cases, ISP/ASP servers provide fulfillment by allowing users to immediately download their contribution after credit approval for electronic documents. For clients that use outsourced services, auditors can sometimes obtain a report on controls from the service organization. According to SAS No. 70, *Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 324.24), as amended, the report would be either (1) reports on controls placed in operation, or (2) reports on controls placed in operation and tests of operating effectiveness.

Fraudulent Financial Reporting

The recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism. Most fraud cases involve management fraud or deliberate deceit by management in working with their auditors.

Not-for-profit organizations face mounting pressure to meet the expectations of "watch dog" groups that monitor the use of their resources. Moreover, the image of the not-for-profit organization has a significant effect on a donor's willingness to contribute. Negative press can considerably decrease future contributions, the availability of volunteers, and public goodwill. Consequently, management of the not-for-profit organization may be subject to unusual pressure to report certain financial results. Such pressure could be a motivation for management to engage in fraudulent financial reporting. Also, significant fraud risk may exist not as an overstatement of operations, but rather as an intentional understatement of operations so that donors perceive a need to continue to give.

Additional factors that not-for-profits confront are the use of ample numbers of volunteer workers who may not be properly trained or supervised; pressure to restrain managerial expenses, resulting in inadequate internal control; scores of locations at which contributions are collected; boards of directors who believe that those involved with the charity would not act in a deceptive manner; inexperienced accounting staff; and dependence on board members to help achieve needed goals and services, resulting in related-party transactions.

Auditing Guidance and Audit Issues

Some of the more common audit issues identified in fraudulent financial reporting include:

1. A willingness by the auditor to accept management's representations without corroboration
2. Allowing the client to unjustifiably influence the scope of auditing procedures
3. Failure to identify risky situations, or ignoring identified audit risks by not applying professional skepticism and revising auditing procedures appropriately

Auditors need to consider such issues as part of their assessment of the risk of material misstatement due to fraud, as required by SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

SAS No. 1, *Codification of Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), states that "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." That Statement establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit conducted in accordance with GAAS. Auditors also need to consider SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), for additional guidance on the consideration of fraud and illegal acts. Also, auditors should refer to SAS No. 1 (AU sec. 230, "Due Professional Care in the Performance of Work"), for additional guidance on professional skepticism. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.

Among other things, SAS No. 99:

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of material misstatement due to fraud, and develop an appropriate audit response.

- Discusses the importance of exercising professional skepticism when considering the possibility that a material misstatement due to fraud could be present.
- Requires a discussion among engagement personnel regarding the risks of material misstatement due to fraud as part of planning the audit. The discussion among the audit team members should consider how and where the not-for-profit's financial statements might be susceptible to material misstatement due to fraud and reinforce the importance of adopting an appropriate mindset of professional skepticism.
- Requires the auditor to gather information necessary to identify risks of material misstatements due to fraud by (1) inquiring of management and others within the NPO about the risks of fraud, (2) considering the results of analytical procedures performed in planning the audit, (3) considering fraud risk factors, and (4) considering certain other information.
- Requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud.
- Requires the auditor to evaluate the NPO's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation.
- Provides guidance on how the auditor responds to the results of the risk assessment by emphasizing that the auditor's response should involve the application of professional skepticism when gathering and evaluating audit evidence. It also requires the auditor to respond to the results in three ways (AU sec. 316.50-.67)

- Requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment.
- Provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others.
- Provides examples of fraud risk factors that, if present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identifed as being present and the auditor's response to those risk factors.

Fraud Risk Factors

The following are a few of the risk factors discussed in SAS No. 99 that may exist at a not-for-profit organization:

- Domination of management by a single person or small group without compensating controls, such as effective oversight by the board of directors or audit committee
- Inadequate monitoring of significant controls
- High turnover of senior management, counsel, or board members
- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitabilty of the entity
- Large amounts of cash on hand or processed
- Lack of appropriate management oversight (for example, inadequate supervision or monitoring, or remote locations)
- Lack of appropriate segregation of duties or independent checks

Regardless of when the auditor discovers fraud risk factors or other conditions related to the fraud risk assessment, the auditor should consider their effect on auditing procedures. The auditor should document the risk factors identified, as well as the auditor's response to the risk factors. The fraud risk factors and other conditions identified may cause the auditor to believe that the planned audit procedures are not sufficient to provide reasonable assurance that the financial statements are free from material misstatement. Accordingly, auditing procedures should be planned and performed to specifically address the identified risks.

Professional Skepticism

Very importantly, auditors must maintain an appropriate attitude of professional skepticism. This means neither assuming that management is dishonest nor assuming unquestioned honesty; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud might include the following:

1. Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions
2. Increased recognition of the need to corroborate management explanations or representations concerning material matters such as further analytical procedures, examination of documentation, or discussions with others within or outside the organization
3. The assignment of more senior or experienced personnel to plan and perform certain auditing procedures

Help Desk—For further information on fraud refer to the AICPA Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (Product No. 006613kk).

Auditing Contributions Receivable

Although contributions receivable are not required to be confirmed under SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards,* vol. 1, AU sec. 330), auditors may nevertheless decide to request confirmation of contributions receivable. Auditors deciding to request confirmation of contributions receivable should consider requesting such confirmations more than just in the first year in situations where the contributions are large pledges and multi-year gifts. (Auditors should refer to SAS No. 67, for guidance about the confirmation process.) Many auditors confirm these types of contributions only in the first year and never again. Thus situations can arise where the contribution is not being properly reflected in subsequent years and the confirmation process would have revealed that. For example, an extension of the repayment terms may result in changes in the estimated fair value which can then lead to improper valuation if not reflected in the accounting records.

Confirming recorded promises to give (contributions receivable) may help the auditor obtain additional evidence regarding the existence of the promise to give, the existence or absence of restrictions and conditions, and the periods over which the promises to give become due. This will provide additional evidence about recognition initially and for subsequent measurement of the contribution receivable. Remember that the fair value of contributions arising from unconditional promises to give cash and noncash assets may change because of (1) changes in the quantity or nature of assets expected to be received (such as in the amounts of future cash flows), (2) changes on the timing of assets expected to be received, and (3) changes in the expected fair value of underlying noncash assets. The confirmation process may help auditors address the financial statement assertions regarding contribution receivables.

Initial confirms are used principally to provide evidence about the existence/occurrence assertion. Subsequent confirms can be used as an additional audit consideration to address completeness, valuation, and presentation and disclosure. In other words, subsequent confirmation procedures may help address changes that have occurred in the contribution receivable, whether collectibility is an issue, if any changes in the fair value of the underlying asset have occurred, and if amounts are appropriately reported in the financial statements. Readers should refer to the "Accounting Issues and Developments" section of this Alert for guidance on accounting for contribution receivables.

Common Engagement Deficiencies

Following are some deficiencies commonly noted on not-for-profit engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. This list continues to include some of the deficiencies identified in the past, indicating continuing problems with the same matters. You should consider reviewing your firm's policies and procedures to see whether your not-for-profit engagements also might have these kinds of issues.

- Failure to identify a voluntary health and welfare organization as such.
- Incorrect classification of contributions as unrestricted, temporarily restricted, or permanently restricted.
- Failure to present a statement of cash flows (as required by Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*).
- Inadequate audit procedures to support the statement of functional expenses.
- Improper accounting for restricted funds.
- Inadequate format, titles, and presentation of financial statements.
- Failure to obtain sufficient evidence to substantiate the value of noncash gifts.

Auditor Association With Municipal Securities Disclosure Documents

The new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* expands its discussion about situations in which an auditor becomes associated with an official statement or other offering document for the issuance of municipal securities and, thus, when the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), as amended by SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Paragraph 16.06 in this Guide states that the auditor becomes associated with the official statement in any of the following situations:

- Assisting in preparing the financial information included in the official statement.
- Reviewing a draft of the official statement at the government's request.
- Manually signing the independent auditor's report included in the official statement.
- Providing a revised independent auditor's report for inclusion in a specific official statement.
- Issuing a comfort letter, the letter described in SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09), as amended, or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement.
- Providing written agreement for the use of the independent auditor's report in the official statement.
- Issuing a report on an attestation engagement relating to the debt offering. (The new Guide includes a discussion on attestation engagements related to the issuance of municipal securities in paragraph 16.20).

Additional information about these seven situations is included in the new Guide. As discussed in paragraphs 16.07 and 16.10 of the Guide, if the auditor is associated with an official statement the guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in those documents. However, the auditor should read the other information and consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AU sec. 550.04-.06) provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. Although an auditor is not required to become associated with a government's official statements except in the situations described in paragraph 16.06 of the Guide, some auditors include a provision in the engagement letter requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision establishes a requirement that the auditor become associated with the government's official statements when the government requests the required permission from the auditor.

In a November 1994 amendment to rule 15c2-12, the SEC required municipal securities dealers to contract with issuers of municipal bonds for them to provide continuing disclosures at certain times for the life of the bond issue. (See the related discussion "Municipal Securities Disclosures" in the "Accounting Issues and Developments" section of this Alert). Continuing disclosures, or secondary market disclosure requirements, are made by issuers providing to nationally recognized municipal securities information repositories and state information repositories annual continuing disclosure documents and material events notices. Material events notices are required for 11 specific events, such as principal and interest payment delinquencies and nonpayment-related defaults. Material event notices are provided through a press release or other written notification on an "as needed" basis and do not involve financial statements.

Paragraph 16.09 in the new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* states that the auditor is not required to participate in or undertake any procedures with respect to a government's continuing disclosure documents, even though they may include audited financial statements. A government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Thus, an auditor's association with other information encompassed by such disclosures cannot be clearly established. Therefore, the provisions of SAS No. 8 do not apply to documents that contain those disclosures. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request should be considered a consulting engagement under the provisions of the AICPA Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards,* Converted to a Guide

Some auditors have been unaware that SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes, including changes resulting from last year's two Yellow Book amendments. To better serve practitioners and increase awareness of the changes made every year to the guidance, SOP 98-3 has been converted to an audit guide and will be available in the third quarter of 2003. Auditors should consider obtaining the newly issued guide inasmuch as significant changes have been made to the guidance since SOP 98-3 was issued. The newly issued guide will continue to be revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and Statements on Auditing Standards.

Accounting Issues and Developments

Split Interest Agreements

Some NPOs have entered into split interest agreements that promised beneficiaries payout rates that are higher than the rates the NPOs are currently earning on their investments. For example, in the 1990s, NPOs may have entered into agreements promising to pay returns of 8 percent to 10 percent, and now the NPOs are earning 2 percent to 3 percent (or less) on the underlying investments. The current market conditions have implications for both accounting and donor relations.

NPOs that did not lock-in returns on investments adequate to fund those obligations to third-party beneficiaries (that is, equal to or exceeding the discount rate used to compute the fair value of the liability) may face the following issues:

- For charitable gift annuities held as general assets and obligations of the NPO, the NPO is in effect incurring economic losses each period in which the interest rate earned is below the initial discount rate. Those losses are not reflected in the financial statements, however, because the interest rate used to discount the liability to the donor is not adjusted to reflect current market conditions. NPOs should consider disclosing such circumstances.
- For annuity trust agreements, continuing to pay a rate greater than is earned raises the possibility that trust assets may be depleted to the extent that at a future date there will be insufficient assets to fund obligations to income beneficiaries. In such circumstances, the trust may eventually have to cease making the payments. Publicity about such conditions and risks, which may not have been clarified in the solicitation or afterwards, could adversely affect the NPO's ability to raise contributions in the future. NPOs should consider disclosing such circumstances. The concern about depleting assets to the extent that payments cease would not apply to typical pooled-life income funds because beneficiaries receive only the income earned on

the trust. It also would not apply to unitrusts because the payment amount changes annually as the fair value of the unitrust assets changes.

Even though unitrusts and pooled-life income funds may not be depleted to the extent that payments cease, the current market conditions may have significantly reduced the income of pooled income funds or the fair value of assets in charitable unitrusts. As a result, the payments to beneficiaries also may have been significantly reduced. NPOs that do not inform beneficiaries about the impact of market conditions on the amount of their distributions before the decreases in payments occur may face problems of donor alienation. The effects of potential donor alienation on future gifts should be considered.

Classification of Net Assets in Consolidation

When the net assets of two or more NPOs are combined into a single set of financial statements—for example as a beneficiary and financially interrelated recipient organization, as parent and subsidiary, or as brother and sister under common control, special consideration should be given to the classification of net assets. To illustrate, assume a parent NPO has NPO subsidiaries. In the subsidiary's separately issued financial statements, certain net assets may be reported as unrestricted because the use of the contributed asset is no more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in the organization's articles of corporations or bylaws (or comparable documents for an unincorporated association). In the consolidated financial statements, however, the unrestricted net assets of the subsidiary arising from contributions (or investment income on donor-restricted endowment funds) should be reported as temporarily restricted net assets if in fact their use is more specific than broad limits resulting from the nature of the parent organization, the environment in which it operates, and so on.

Example: A membership association (Parent) has an educational subsidiary whose mission is to provide scholarships. Donors make unrestricted contributions to the educational subsidiary with the intent that the subsidiary use the contributions to support its mission, including granting scholarships, and incurring fund-raising and general and administrative expenses. The gifts to the educational subsidiary are therefore classified as increases in unrestricted net assets, but if the educational subsidiary's financial statements are consolidated with the membership association (Parent), the classification of the net assets of the subsidiary should be adjusted to reflect that they are donor-restricted net assets from the perspective of the Parent's consolidated financial statements. The unrestricted net assets of the educational subsidiary resulting from contributions (or investment income on donor-restricted endowment funds) should therefore be reported as temporarily restricted net assets in the Parent's consolidated financial statements.

In summary, if the net assets or results of operations of an organization with a narrow mission are combined (via consolidation, combination, or equity method accounting) with the net assets of an organization with a broader mission, the classification of the net assets of the organization with the narrower mission may need to be adjusted to reflect donor-imposed restrictions if the source of the net assets was contributions (or investment income on donor-restricted endowment funds). The classification of the unrestricted net assets of the organization with the narrower mission would not be adjusted if those net assets arose from exchange transactions, such as fees or ticket sales.

Municipal Securities Disclosures

Issuers of municipal bonds, including not-for-profit health care organizations that are conduit issuers of municipal bonds, are exempt from the registration and reporting requirements of the federal securities laws. However, they are not exempt from antifraud provisions of the federal securities laws, which forbid making misleading statements in, or omitting material facts from, disclosures made in official statements and annual financial filings and other statements speaking to the market. Briefly, the antifraud provisions apply to a municipal issuer whenever it releases information to the public that is reasonably expected to reach investors and the trading markets. If a statement is made reaching markets or investors, the antifraud provisions apply, regardless of whether the statement is made on paper or delivered electronically. The SEC Interpretive Release *Use of Electronic Media* provides interpretive guidance to corporate and municipal issuers on how securities fraud laws apply to such matters as the electronic delivery of documents and electronic disclosure.

The principal sources of SEC guidance on the operation of the municipal disclosures framework and application of the antifraud provisions are (1) SEC releases, including the March 1994 SEC Interpretive Release No. 34-33741, *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others,* and SEC Release No. 34-34961, *Secondary Market Disclosure,* an amendment to Rule 15c2-12 issued in November 1994; and (2) SEC enforcement actions in the municipal sector involving the antifraud provisions. As of writing this Alert, there were no recent releases from the SEC relating to the municipal securities market.

For additional information on the SEC and municipal securities developments, see the SEC Web site, www.sec.gov. This site includes a page providing a shortcut to information on the SEC Web site for municipal issuers and other participants in the municipal securities markets.

See the related discussion “Auditor Association With Municipal Securities Disclosure Documents” in the “Audit and Attestation Issues and Developments” section of this Alert.

Losses on the Investments of Donor-Restricted Endowment Funds

Many not-for-profit organizations have endowment funds that are commingled and invested as a pool. The funds combined in that pool are usually a mix of true endowments, term endowments, and quasi-endowment funds (also sometimes called funds functioning as endowment.) Questions have arisen as to how the losses on the investments of the pool should be classified.

Paragraphs 11, 12, and 15(d) of FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, state that:

> A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. Unless gains and losses are temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, gains and losses on investments are changes in unrestricted net assets. For example, if a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to that same permanent restriction unless the donor specifies otherwise. However, if a donor allows the organization to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires an amount be retained permanently. Instead, those gains are unrestricted if the investment income is unrestricted or are temporarily restricted if the investment income is temporarily restricted by the donor.
>
> In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets.
>
> For each period in which a statement of financial position is presented, a not-for-profit organization shall disclose the aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

To determine how the losses on an investment pool should be classified, an organization should look to the restrictions on the individual funds that constitute the pool rather than to the aggregate of all investments in the pool. The loss on the pool assets is unitized and allocated to each individual fund. Then the donor restrictions on the net assets of the individual funds (or the lack of donor restrictions) determine the classification of that fund's loss.

Example: Assume an organization has pooled the investments of three donor-restricted endowment funds and one quasi-endowment fund. The quasi-endowment fund was established by the governing board using unrestricted net assets. The investments in the pool have a fair value of $1,575,000, and there are 1,575 units with a value of $1,000 each.

The first donor-restricted endowment fund (Fund 1) is very old—it owns 1,000 units with a fair value of $1,000,000—$100,000 of permanently restricted net assets, $350,000 of temporarily restricted net assets, and $550,000 of unrestricted net assets. The second donor-restricted endowment fund (Fund 2) is just a few years old. It owns 50 units with a fair value of $50,000—$40,000 of permanently restricted net assets, $2,000 of temporarily restricted net assets, and $8,000 of unrestricted net assets. The third donor-restricted endowment fund (Fund 3) is new—it owns 25 units with a fair value of $25,000—$25,000 of permanently restricted net assets. The gift agreements that established the donor-restricted endowment funds do not have stipulations about what should be done if the fund suffers a loss. The quasi-endowment fund (Fund 4) owns 500 units with a fair value of $500,000, all of which is unrestricted.

The market value of the investments of the pool falls to $1,417,500, or a loss of $157,500. How should that loss be classified?

Each unit is now worth $900 ($1,417,500/1,575), for a loss of $100 per unit. As a result, Fund 1 has a fair value of $900,000 and a loss of $100,000. Fund 1's loss of $100,000 reduces temporarily restricted net assets by $100,000 because Fund 1 had temporarily restricted net assets of $350,000 before the loss occurred.

Fund 2 has a fair value of $45,000 and a loss of $5,000. Fund 2's loss reduces temporarily restricted net assets by $2,000 and unrestricted net assets by $3,000. The loss reduces the net appreciation of the fund from prior years that were classified as temporarily restricted net assets until those net assets are entirely depleted, then it reduces the net appreciation that was classified as unrestricted net assets.

Fund 3 has a fair value of $22,500 and a loss of $2,500. Fund 3's loss reduces unrestricted net assets by $2,500 because the fund had no temporarily restricted net assets. Although the fund has no net appreciation from prior years, the loss does not reduce the permanently restricted net assets. FASB Statement No. 124 requires losses to be classified as decreases in unrestricted net assets unless there is a donor's explicit stipulation or a law that extends a donor's stipulation to the loss.

Fund 4 has a fair value of $450,000 and a loss of $50,000. Fund 4's loss of $50,000 reduces unrestricted net assets because the entire fund was free of donor restrictions.

Thus, the $157,500 loss on the investments of the pool is classified as a decrease in temporarily restricted net assets of $102,000 and a decrease in unrestricted net assets of $55,500. The temporarily restricted net assets of Fund 1 cannot be used to absorb the losses in Funds 2, 3, or 4.

The organization should disclose that the aggregate deficiency for all donor-restricted endowment funds is $2,500, which is the amount by which the fair value of Fund 3's assets ($22,500) is less than the amount it should maintain permanently ($25,000). Funds 1 and 2 have values greater than the amount they are required to keep permanently.

If the market recovers and the fair value of the investments increases after the end of the fiscal year, paragraph 13 of FASB Statement No. 124 says:

> If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law,[4] gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

4. Donors that create endowment funds can require that their gifts be invested in perpetuity or for a specified term. Some donors may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions. It is generally understood that at least the amount of the original gift(s) and any required accumulations is not expendable, although the value of the investments purchased may occasionally fall below that amount. Future appreciation of the investments generally restores the value to the required level. In states that have enacted its provisions, the Uniform Management of Institutions Funds Act describes "historic dollar value" as the amount that is not expendable.

Because the fair value of Fund 3 is $2,500 less than the amount that should be maintained permanently, the first $2,500 of gains earned by Fund 3 are classified as an increase in unrestricted net assets. Any additional gains are classified as permanently restricted, temporarily restricted, or unrestricted in accordance with the donor stipulations.

Auditors should test the allocation of losses to individual endowment funds. The classification of the loss within the individual endowment fund depends on the amount of net appreciation of the fund in prior years and the classification of that net appreciation in accordance with explicit donor restrictions or a law that extends the donor restrictions to the net appreciation. (In many states, the Uniform Management of Institutional Funds Act, as adopted, provides the relevant law.) Auditors should review gift instruments and state law to determine the amount of the fund that should be permanently retained and consider whether losses, if any, reduce the fair value of the assets of the fund to an amount that is less than that permanent amount. A loss first reduces the temporarily restricted net appreciation of the fund until it is entirely depleted, then it reduces the unrestricted net appreciation of the fund. If there is no net appreciation in the fund from prior years or if the loss exceeds the net appreciation from prior years, the loss reduces unrestricted net assets. The deficits for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law should be disclosed by the organization in its financial statements.

The classification of losses on the investments of a pool is complex and time-consuming. Both organizations and their auditors should allow adequate time to perform necessary procedures properly.

Accounting for Cash Contributions Receivable

Auditors should be reminded that contributions revenue should be measured at the fair value (using quoted market prices if available) of the assets or services received or promised or at the fair value of liabilities satisfied. But, net realizable value may be used when the contributions arise from unconditional promises to give and are expected to be collected within one year of the financial statement date.

The fair value of contributions arising from unconditional promises to give cash should be determined based on the present value of the estimated future cash flows. For example, initial recognition of an unconditional promise to give cash of $1,000 that is expected to be collected in five years should be measured and reported as follows. First the NPO should determine the estimated future cash flows from the promise to give cash. The not-for-profit should consider when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection history and its policies in connection with the enforcement of promises to give, and other factors concerning the receivable's collectibility in determining the estimated future cash flows. In this case we will use $700 as the estimated future cash flows from the promise. (Note that the organization does not report bad debt expense of $300—the difference between the $1,000 promised and the $700 expected to be collected.) Then the NPO should determine the present value of the estimated future cash flows which should be measured using a risk-free rate of return appropriate for the expected term of the promise to give. The amount to be discounted is considered to be free from credit risk since the donor's credit rating and other factors affecting the donor's ability to honor the promise to give would be considered already in determining the estimated future cash flows of unconditional promises to give cash. In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables,* the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.

Some donors extend payment terms longer than what was called for in original gifts. More often than not, the NPO has not updated the accounting or calculations for discounted future amounts to reflect longer terms or, in extreme cases, revising uncollectible amounts. Auditors should consider subsequent measurement of unconditional promises to give cash and noncash assets because the fair value of the contributions may change if the following conditions occur: (1) changes in the quantity or nature of assets expected to be received, such as changes in the amounts of future cash flows, and (2) changes in the timing of assets expected to be received. Readers should refer to footnote 25 of paragraph 5.70 of the Audit and Accounting Guide *Not-for-Profit Organizations* since the Guide does not address changes in the timing of assets expected to be received. Since in the current environment we are more concerned with losses we will discuss only losses here. Decreases due to changes in the quantity or nature of assets expected to be received should be recognized in the period(s) in which the expectation changes. Those decreases should be reported as expenses or losses (bad debt) in the net assets class in which the net assets are represented. Decreases in contributions because of changes in the amounts of assets expected to be received should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

Functional Classifications of the Costs of Soliciting Exchange Transactions

Management and general activities are defined as those activities that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. Among other activities, they include soliciting revenue from exchange transactions, such as government contracts and related administrative activities. Costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not), should be classified as management and general expenses.

Accounting for Fund-Raising Costs

Fund-raising costs, including the cost of special fund-raising events, are incurred to induce donors to make contributions to an organization and should be expensed as incurred. Incurred is defined as when the item or service has been received. Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods but still should be expensed as incurred. For example, fund-raising materials, such as brochures, sitting in a warehouse should be expensed even though they have not yet been mailed. Also included as an expense when incurred are any salaries or consulting fees to develop the brochures.

Derivative Accounting and Split Interest Agreements

Under FASB Derivatives Implementation Group (DIG) Issue B35, many split interest agreements will require bifurcation and derivative accounting. For lead interest agreements in particular, in circumstances in which the NPO has a liability to a beneficiary, even if the lead interest is a fixed payment, as long as the liability is variable and the agreement is period certain, it will qualify as a derivative. This is because the liability to the third party will usually vary based on the fair value of investments.

Required Detailed Disclosures Concerning Contributions of Services

As a reminder, the following disclosures should be included in the notes to the financial statements concerning contributions of services received during the period: (1) the nature and extent of contributed services received by the organization; (2) a description of the programs or activities for which the services were used; and (3) the amount of contributed services recognized during the period. NPOs are also encouraged, if practicable, to report in the notes to the financial statements the fair value of contributed services received but not recognized.

Lapsing of Restrictions in Circumstances in Which Both Time and Purpose Restrictions Exist

In circumstances in which both donor-imposed purpose and donor-imposed time restrictions exist, expenditures meeting the purpose restriction should be made simultaneously with or after the time restriction has expired in order to satisfy both the purpose and time restrictions and result in a reclassification of net assets from temporarily restricted to unrestricted. In other words, donor-imposed time restrictions, if any, must be met before expenditures can result in purpose restrictions being met. Paragraph 150 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* provides that "the [FASB] believes that it is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support activities in each period in which a payment is scheduled". The AICPA staff is considering developing a Technical Practice Aid (TPA) to address this issue. Readers may refer to FASB Statement No. 116, footnote 5 and paragraph 150, for additional guidance.

TPA 6140.12, *Nondiscretionary Assistance Programs*

The AICPA Accounting Standards team recently released another nonauthoritative question and answer (Q&A), commonly referred to as a TPA, pertaining to not-for-profit organizations. TPA 6140.12, *Nondiscretionary Assistance Programs,* has been posted to the AICPA Web site at www.aicpa.org/members/div/acctstd/general/tpafin4.htm. It will also be included in the next update of the AICPA publication titled *Technical Practice Aids*, copies of which are available through the AICPA order department at (888) 777-7077. AICPA members with questions on these TPAs should call the AICPA's Technical Hotline, which provides nonauthoritative guidance on accounting and attest issues, at (888) 777-7077.

Auditing and Attestation Pronouncements and Guidance Update

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter and Journal of Accountancy*.

To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 97	*Amendment to Statement on Auditing Standards No. 50*, Reports on the Application of Accounting Principles
SAS No. 98	*Omnibus Statement on Auditing Standards—2002*
SAS No. 99	*Consideration of Fraud in a Financial Statement Audit*
SAS No. 100	*Interim Financial Information*
SAS No. 101	*Auditing Fair Value Measurements and Disclosures*
SOP 02-1	*Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administration Code*
SSAE No. 12	*Amendment to Statement on Standards for Attestation Engagements No. 10*, Attestation Standards: Revision and Recodification

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

The Auditing Standards Board issued SAS No. 101, Auditing Fair Value Measurements and Disclosures (AICPA, *Professional Standards*, vol. 1, AU sec. 328), in January 2003 to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, it addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under generally accepted accounting principles (GAAP). For example, GAAP may require that some fair value changes be reflected in net income and that other fair value changes be reflected in other comprehensive income and equity. Of course, in not-for-profit organizations, all changes are included in the change in net assets for the period.

While SAS No. 101 provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation, such as the physical condition of the asset. Refer to the Statement for effective date information.

New Auditing Interpretations

Auditing Interpretations are issued by the Auditing Issues Task Force of the Auditing Standards Board (ASB) to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB statements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations become effective upon their publication in the *Journal of Accountancy*.

The new Interpretations listed below are available on the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

> Interpretation No. 12, "The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption," of SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 9420).

> Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508).

> Interpretation No. 2, "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326).

Interpretation No. 16, "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508).

Accounting Pronouncements and Guidance Update

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	R*escission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*
FASB Statement No. 146	*Accounting for Costs Associated with Exit or Disposal Activities*
FASB Statement No. 147	*Acquisitions of Certain Financial Institutions*
FASB Statement No. 148	*Accounting for Stock-Based Compensation—Transition and Disclosure*
FASB Statement No. 149	*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150	*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46	*Consolidation of Variable Interest Entities*
FASB Technical Bulletin No. 01-1	*Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
SOP 02-2	*Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*

FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

The FASB issued its Statement No. 149 in April 2003, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Refer to the Statement for effective date information.

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*

This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* addresses consolidation by business enterprises of variable interest entities,[4] which have one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.

2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:

4. The exposure draft that preceded this Interpretation referred to the entities subject to its requirements as special-purpose entities (SPEs). Because some entities that have been commonly referred to as SPEs may not be subject to this Interpretation and other entities that have not commonly been referred to as SPEs may be subject to this Interpretation, the Financial Accounting Standards Board decided to use the term *variable interest entity*.

a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights
b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities
c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses.

Not-for-profit organizations subject to the consolidation requirements of SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations,* are not subject to FASB Interpretation No. 46, except that they may be related parties for purposes of applying paragraphs 16 and 17 of the Interpretation. In addition, a not-for-profit entity used by a business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions FASB Interpretation No. 46 is subject to the Interpretation. Readers should refer to the Interpretation for additional exceptions to the scope of this Interpretation and for the effective date information.

SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*

This SOP amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide) to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended. This SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.

- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise. Refer to the Statement for effective date information.

Upcoming Qs&As on FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*

The Accounting Standards Team of the AICPA is releasing question and answer guidance about key FASB Statement No. 136 issues. These Q&As will be posted to the AICPA Web site in June and will be incorporated into the AICPA TPAs afterwards. Readers should be alert to the issuance of this guidance.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that are especially relevant to the NPO industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.htm
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB has issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements (Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.)
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Combinations of Not-for-Profit Organizations

In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of NPOs that is separate from its business combinations project. As a result of that decision, combinations of NPOs are excluded from the scope of FASB Statement No. 141, *Business Combinations.* The FASB also agreed to delay the effective date of FASB Statement No. 142, *Goodwill and Other Intangible Assets,* as it applies to combinations of NPOs, until the FASB addresses the issues related to such combinations.

The objective of this project is to develop guidance on the accounting and reporting for combinations of NPOs. As of the March 17, 2003 meeting, the FASB completed its deliberations related to the following issues:

- The method of accounting for combinations of NPOs
- The criteria to be used to identify the acquiring NPO
- Recognition of goodwill subsequent to acquisition
- Recognition of goodwill at date of acquisition
- The disclosures required by NPOs
- The effective date and transition method to be applied by NPOs

For a tentative summary of the decisions reached by the Board so far on the combinations of NPO organizations go to www.fasb.org and into project updates. An exposure draft is planned for the third quarter of 2003. Readers should be alert for the issuance of a final Statement.

Readers should also be aware of the ongoing work by the FASB on its consolidation project. On February 23, 1999, the FASB released an exposure draft (revised) of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*, which would supersede FASB Statement No. 94 and amend ARB No. 51, APB Opinion Nos. 16 and 18, and FASB Statement Nos. 15, 57, and 65. The provisions of SOP 94-3 will be reconsidered as the FASB issues final standards. In the meantime, readers should be alert to the fact that NPOs continue to be covered by SOP 94-3 in this area. In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities.* The FASB now plans to continue its consideration of the broader proposals in the 1999 exposure draft.

Emerging Issues Task Force Discussion on Other-than-Temporary Impairment

The Emerging Issues Task Force (EITF) of the FASB discussed proposed guidance for assessing other-than-temporary impairment at the March 20, 2003 EITF meeting. This proposed guidance would apply to investments accounted for under the cost method or the equity method, investments classified as either available-for-sale or held-to-maturity under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (including individual securities and mutual funds), and investments accounted for under FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations.* The guidance would not apply to investments within the scope of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." The proposed guidance is expected to address the following: (1) determination as to whether an investment is impaired, (2) determination as to whether an impairment is other-than-temporary, and (3) recognizing an impairment loss equal to the difference between the investment's carrying amount and its fair value (measured as of the date of the financial statements). Additional discussion is anticipated at a future EITF meeting. Readers should be alert to any final consensus reached on this issue.

Proposed FASB Staff Position, *Applicability of FASB Interpretation No. 46*, Consolidation of Variable Interest Entities, *to entities subject to the AICPA Audit and Accounting Guide* Health Care Organizations

The FASB has issued a proposed FASB Staff Position (FSP) on FASB Interpretation No. 46. The FSP addresses whether health care NPOs should follow FASB Interpretation No. 46. Paragraph 4(a) of the Interpretation provides an exception for not-for-profit organizations subject to SOP 94-3. Not-for-profit organizations subject to the AICPA Audit and Accounting Guide *Health Care Organizations* (Audit Guide) are not subject to SOP 94-3. The FSP is expected to answer the question "Do the requirements of FASB Interpretation No. 46 apply to those organizations?" The FSP states that all not-for-profit organizations are excluded from FASB Interpretation No. 46, including health care organizations subject to the Audit Guide. However, a not-for-profit entity used by a business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 is subject to the Interpretation. Readers should be alert to any final issuance.

AICPA Audit and Accounting Products and Services

AICPA

Web Site

AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting and auditing. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a "Talk to Us" section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Customer Service Center)

To order AICPA products, call the Customer Service Center at (888) 777-7077 or fax to (800) 362-5066. The best times to call are 8:30 A.M. to 11:30 A.M. and 2:00 P.M. to 7:30 P.M., Eastern Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Industry Conference

The AICPA will hold its Ninth Annual Not-for-Profit Organizations Industry Conference on June 12-13, 2003 (with preconference workshops on June 11), in Washington, D.C. The conference is designed for both practitioners and not-for-profit organization financial executives, and will provide technical information for those decision makers. Also coming up is the AICPA Governmental and Not-for-Profit Training Program on October 20-22, 2003 in Baltimore, MD and the AICPA Not-for-Profit Financial

Leaders Forum on November 20-21, 2003, in San Francisco, CA. For further information, call the AICPA CPE Conference Hotline at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Continuing Professional Education Courses

The AICPA offers many continuing professional education (CPE) courses related to NPOs, many of them available for both group study and self-study. Among the available titles are the following:

- Accounting and Reporting Practices of Nonprofit Organizations (Product No. 743269kk)
- Form 990: AICPA's Answer to Unlocking the Tax Complexities (Product No. 731053kk)
- Advanced Accounting and Auditing Problems for NPOs (Product No. 730127kk)
- Advanced Auditing of HUD-Assisted Projects (Product No. 730187kk)
- Applying A-133 to Nonprofit and Governmental Organizations (Product No. 730197kk)
- Audits of HUD-Assisted Projects (Product No. 730292kk)

- Analytical Procedures for Nonprofit Organizations (Product No. 730211kk)
- Cost Allocation Methods for Not-for-Profit Organizations (Product No. 730411kk)
- Managing Nonprofit Organizations Like a Business (Product No. 730342kk)
- NEW EDITION! Nonprofit Accounting and Auditing Update (2002-2003 Edition) (available in text [Product No. 732066kk] and video [Product No. 182065kk])
- Nonprofit Auditing: Auditing Financial Results and Compliance Requirements (Product No. 737052kk)
- Tax Mysteries of Private Foundations (Product No. 732242kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (Product No. 734405kk)
- Getting Started with Not-for-Profit Organization Tax Issues (Product No. 733803kk)
- Nonprofit Organizations Guide to Advanced Tax Planning (Product No. 736763kk)
- Using the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
- Workpaper Techniques for Government and Nonprofit Organizations (Product No. 732630kk)
- The Revised Yellow Book: Government Auditing Standards (Product No. 736110kk)
- Using Competition for Performance Improvement: A Resource for Practitioners Advising Governments and Not-for-Profits (Product No. 056507kk)

For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today*'s top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Not-for-Profit Organizations Checklists

The AICPA Accounting and Auditing Publications Team publishes *Checklists and Illustrative Financial Statements for Not-for-Profit Organizations* (Product No. 008983kk), a nonauthoritative publication designed to help those preparing reports and financial statements of NPOs.

Practice Aids

Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations is a comprehensive Practice Aid (Product No. 006605kk) that illustrates a wide variety of financial statement formats and disclosures for NPOs.

Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, is a two-volume set (Product No. 006602kk) containing comprehensive analyses of the OMB's revisions to its Circulars for performing single audits, numerous checklists, and illustrative examples, and an illustrative case study of the single audit process.

Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide (Product No. 006613kk), is a Practice Aid that provides CPAs with the most recent information related to the implementation of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*

Technical Practice Aids

AICPA Technical Practice Aids includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. Sections 6140 and 6960 of *Technical Practice Aids* include questions and answers specifically pertaining to NPOs. *Technical Practice Aids* is available both as a subscription service (Product No. G01013kk) and in paperback form (Product No. 005142kk).

> **Help Desk**—AICPA publications can be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, or faxing a request to (800) 362-5066.

References for Additional Guidance

General Accounting Office

The General Accounting Office (GAO) home page, on the Internet at www.gao.gov, contains links to hundreds of reports and testimony made before Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000; fax (202) 512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

GAO's Web site is updated daily and also includes Comptroller General decisions and legal opinions; GAO policy documents; and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (202) 512-1800; fax (202) 512-2250; or bookstore.gpo.gov/index.html.

- *Government Auditing Standards, 1994 Revision*—These standards relate to financial and performance audits of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. (GPO Stock No. 020-000-00-265-4) There also is a codification of the 1994 standards that includes the Government Auditing Standards Amendments on the GAO Web site.

- *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*—This amendment establishes a fieldwork standard requiring documentation in the planning of financial statement audits in certain circumstances. (GPO Stock No. 020-000-00275-1)

- *Government Auditing Standards: Amendment No. 2, Auditor Communication*—This amendment requires specific communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting. It also requires the auditor to emphasize in the auditor's report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements. (GPO Stock No. 020-000-00274-3)

- *Government Auditing Standards: Amendment No. 3, Independence*—This amendment establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It addresses a range of auditor independence issues, including restrictions on nonaudit services.

- *Interpretation of Continuing Education and Training Requirements*—*Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This

Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community.

Other Guidance

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2002/03* (Product No. 022333kk), and AICPA *Compilation and Review Alert—2002/03* (Product No. 022303kk). These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066. Obtaining product information and placing on-line orders can be done at www.CPA2biz.com. (The 2003/04 versions of these publications will be issued later in 2003).

Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (800) 748-0659.

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This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2002*. The *Not-for-Profit Organizations Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may e-mail these comments to lwest@aicpa.org or write to:

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APPENDIX
The Internet—An Auditor's Research Tool

Can auditors use the Internet to perform more efficient audits?

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to industry statistics, resources for not-for-profit organizations (NPOs) and their finance professionals, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to:

- Obtain audit and accounting research information
- Obtain texts, such as audit programs
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client's Web site
- Obtain information on professional associations

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of NPOs may find useful.

Name of Site	*Content*	*Internet Address*
American Institute of CPAs	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	www.aicpa.org
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
Action Without Borders	Includes a directory of not-for-profit organizations and volunteering resources, a newsletter on not-for-profit organization issues, and job postings	www.idealist.org
American Society of Association Executives	Provides resources to assist association executives and individuals from for-profit companies that provide products and services to the association community	www.asaenet.org
BBB Wise Giving Alliance	Promotes giving and helps contributors obtain accurate information about charitable organizations	www.give.org
Board Source	Resources to help strengthen not-for-profit organization boards of directors	www.boardsource.org/main.htm
The Chronicle of Philanthropy	Articles from the *Chronicle of Philanthropy* newspaper and links to other sites	www.philanthropy.com
CompassPoint Nonprofit Services	Workshops, consulting, publications, and other information and resources of interest to managers of not-for-profit organizations	www.supportcenter.org

Name of Site	*Content*	*Internet Address*
Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	www.cof.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Department of Housing and Urban Development: Office of Inspector General Real Estate Assessment Center	Information on programs, resources and other matters	www.hud.gov/offices/oig/ www.hud/gov/offices/reac
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	www.electronicaccountant .com
Financial Accounting Standards Board	Information on the activities of this standard-setting body	www.fasb.org
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	www.fedworld.gov
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	www.fsforum.com
The Foundation Center	Information for not-for-profit organizations, donors, and researchers	www.fdncenter.org
Giving USA	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	www.aafrc.org
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	www. gao.gov

Name of Site	*Content*	*Internet Address*
Guidestar	Information on not-for profit organizations and news and resources for not-for-profit organizations and donors	www.guidestar.org
Guide to WWW For Research and Auditing	Basic instructions on how to research	www.tetranet.net/
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiative, and citizen action	www.indepsec.org
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt organizations	www.irs.gov/
Internet Nonprofit Center	Includes the nonprofit locator, frequently asked questions, and other information	www.nonprofits.org
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	www.mapnp.org
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	www.nacubo.org
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of not-for-profit organizations	nccs.urban.org
The Nonprofit Genie	Advice, links to other sites, publications, and other information on not-for-profit organization management	www.genie.org
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	www.not-for-profit.org
The Nonprofit Risk Management Center	Provides information to help not-for-profit organizations control their risks	www.nonprofitrisk.org

Name of Site	*Content*	*Internet Address*
The Nonprofit Times Online	Articles from the *Nonprofit Times* newspaper and links to other sites	www.nptimes.com
Tax Analysts Online	Provides information on current tax developments	www.tax.org
U.S. Department of Education	Information on programs, resources, and other matters	www.ed.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
U.S. Office of Management and Budget	OMB information and literature	www.whitehouse.gov/OMB/
Vision Project	Information on the profession's Vision Project	www.cpavision.org

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